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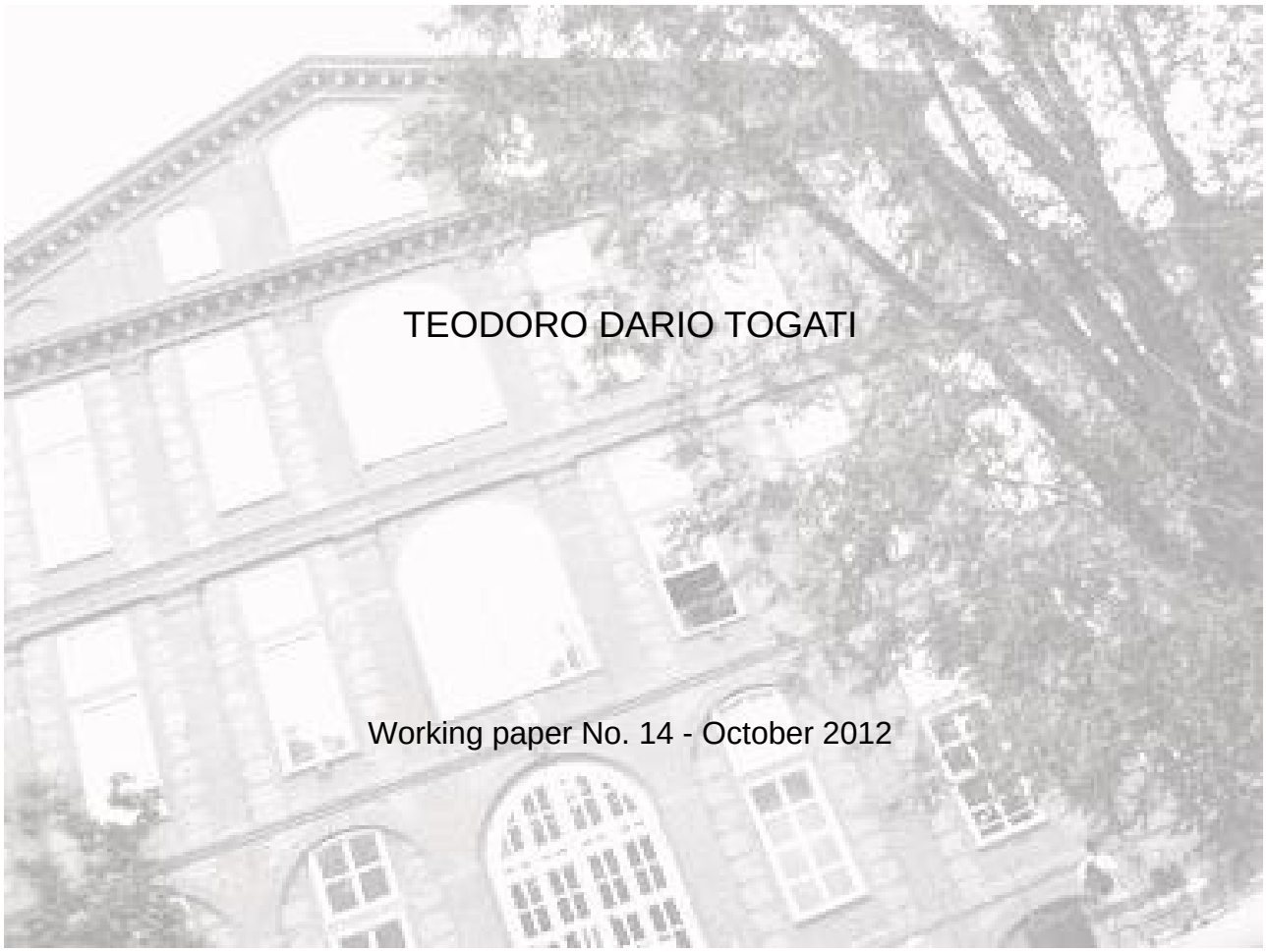

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How to explain the persistence of the Great Recession? A Balanced Stability Approach

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The Great Recession (GR) brings about a stalemate in macroeconomics. On the one hand, while describing the immediate effects of the GR, standard models fail to account for its persistence. On the other, heterodox approaches do not regain consensus as they fail to devise an alternative method for capturing the deep causes of the GR that account for its persistence in a systematic way. This paper fills this gap by proposing a new framework called Balanced Stability Approach. Unlike standard macro which takes stability for granted, it provides a balanced assessment of stability, considering both threats and opportunities for phenomena such as the so-called New Economy (NE) on a par. On these grounds, the paper draws the conclusion that the persistence of the GR is due to a low level of aggregate demand rooted in the structural changes generated by the NE.

Key words: **Economic crisis, stability, deductivist methods, macroeconomics, Keynesianism**

JEL classifications: **B50, E32, E60**

1. Introduction

The Great Recession (GR) brings about a stalemate in macroeconomics. On the one hand, as even orthodox economists recognize, the standard paradigm is in crisis. In particular, while describing the immediate effects of the GR on output and employment by introducing exogenous shocks, such as financial frictions (see e.g. Hall 2010, Woodford 2010), reliance on price rigidities apart (see e.g. Woodford, 2010, p.39), standard models fail to explain its persistence[1]. According to this paper, the key reason is that standard models and regression techniques are good only at identifying the 'proximate' rather than the 'deep' causes of the GR: i.e. they can show at best that a financial crisis causes recession, not why this crisis occurred. On the other, while providing valuable insights into the question, heterodox approaches do not seem to regain consensus, despite claims about the 'Return of the Master' (see e.g. Skidelsky, 2009, Davidson, 2009).

Two main reasons account for this state of affairs. First, the standard deductivist method based on the rational agent is regarded as the 'natural' engine of analysis by most economists, including distinguished critics of the current orthodoxy (e.g. Stiglitz, 2010, Akerlof and Shiller, 2009). Second, despite the blossoming of alternative interpretations (see, for example, the contributions included in Kates, 2010; 2011, Arestis, Sobreira and Oreiro, 2011, Brancaccio and Fontana, 2011), many heterodox economists fail to provide a complete deep-causes account of the GR. While managing to explain the financial crisis, they do so only by tracing it to more significant developments within the financial sector itself, such as irrational exuberance, low interest rate policy, liberalisation processes favouring financial innovation, the worsening of agents' financial conditions, broadening income gaps or asymmetric information. In this way, however, they implicitly assume that financial instability alone accounts for

[1] As Hall notes, such frictions 'cannot explain why GDP and employment failed to recover once the financial crisis subsided -- the model implies a recovery as soon as financial frictions return to normal.' (Hall, 2010, p.3).

general instability, thus somehow neglecting the fact that 'the global crisis clearly has both financial- and real-sector roots' (Crotty, 2009, p. 564).

To pursue a deep-causes account, one needs instead to adopt a broader perspective of the New Economy (NE), also considering other 'real' trends, such as globalization and technological change, which could, in principle explain the financial crisis. In other words, this account calls for a complex link between finance and the real sector going both ways. This is not to say that in the literature this step is never made. Some authors do recognize, for example, that the GR is rooted in growing inequality trends which undermine aggregate demand (see e.g. Fitoussi and Stiglitz, 2009 and many essays in Brancaccio and Fontana, 2011).[2] However, these authors typically fail to converge on a unifying alternative method to grasp these 'real' developments concerning aggregate demand in a systematic way.

For this reason, this paper proposes a way out of the stalemate by proposing a new approach to study the persistence of the GR called Balanced Stability Approach (BSA). Based on an evolutionary perspective, this approach seeks to broaden the scope of macroeconomic analysis beyond the narrow confines established by standard methods. Four main features of this approach can be distinguished.

First, it rejects the methodological assumptions underlying current models. In particular, writing about the GR, and 'just assuming' as a matter of faith that the economy is internally stable, as standard macroeconomists do, is like writing *Hamlet* without the prince.[3] This assumption leads them to regard fluctuations

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[2] **'The aggregate demand deficiency preceded the financial crisis and was due to structural changes in income distribution. Since 1980, in most advanced countries... inequalities have surged in favour of high incomes. ... This trend has many causes, including asymmetric globalization (with greater liberalization of capital than of labour markets), deficiencies in corporate governance and a breakdown of the egalitarian social conventions that had emerged after WWII' (Fitoussi and Stiglitz, 2009, pp. 3-4).**

[3] **As Lucas remarked in 2007 when the GR was well on its way:**

> **So I am skeptical about the argument that the subprime mortgage problem will contaminate the whole mortgage market, that housing construction will come to a halt, and that the economy will slip into a recession. Every step in this chain is questionable and none has been quantified. If we have learned anything from the past 20 years it is that there is a lot of stability built into the real economy'.**
>
> **(Lucas, 2007).**

as if they were always regular, short-lived, phenomena, induced by a single exogenous cause. In other words, it leads them to overemphasize 'Opportunities' (Os) and dismiss internal 'Threats' (Ts) of relevant phenomena, such as the New Economy (NE). In the standard literature, for example, the latter has been celebrated as a golden age of capitalism, generating the Great Moderation, thanks to higher market flexibility, improved information, or decreasing risks due to financial innovation resulting from the application of the new technologies.

Secondly, the BSA pursues an endogenous approach to stability. This means considering capitalism neither as a priori stable nor unstable, but as a real source of Ts, which must be weighed against the Os in actual historical contexts, such as the NE. While accepting Keynes's vision stressing how private sector instability, as reflected in low aggregate demand, may result from the workings of an abstract monetary economy, the BSA seeks to draw conclusions about stability on the grounds of actual tendencies of real-world economies.

Thirdly, in order to build a truly general approach, the BSA provides a full account of the Ts side at the macro level. This is possible because it adopts a broader interpretation of the NE than alternative approaches focusing on individual key instability factors, such as technology (e.g. Perez, 2009) or finance (e.g. Dow, 2011, Wray, 2010). The BSA views the NE as involving a higher degree of interconnectedness, both within and between sectors of the economy, than previous stages of development. This means stressing that the NE presents significant dimensions of structural change, namely 'objective' factors, such as faster globalisation, financialization and more rapid technological growth, policy and institutional trends as well as 'subjective' factors which can be discussed in terms of agents' 'conventional perceptions'.

To pursue this analysis, the BSA goes beyond standard aggregates and adopts a multidimensional and interdisciplinary perspective. In principle, it considers indicators reflecting socio-economic and psychological factors (including those that influence people's 'happiness', in line with ongoing efforts to 'go beyond the

GDP' as a measure of well-being).[4] Moreover, it integrates economic concepts with broadly cultural labels, such as those proposed by the Italian writer Italo Calvino in his 1986 Harvard Lectures to categorize the new millennium (see Calvino, 1993).

Fourthly, the BSA provides a 'deep' causes account of the GR, stressing that its persistence is due to low aggregate demand rooted in the structural changes generated by the NE, rather than in price rigidities.

To deal with these issues, this paper is organized as follows. Section 2 takes stock of the neglected Ts of the NE by criticizing the deductivist method and developing the BSA. Section 3 shows instead how this approach manages to explain the persistence of the GR.

2. The BSA

In this section, I provide an outline of the BSA aimed at considering the Ts of the NE in a more balanced way than standard macro does on the grounds of its deductivist method. For this purpose, it is necessary to draw a map of the relevant Ts. In what follows, I show that they fall into two categories: those deriving from standard theory itself in view of its influence upon policymakers and agents' expectations and those that can be uncovered only by dropping the standard methodological features. Strictly speaking, this does not mean that in standard macro negative events such as recessions are not contemplated. Indeed, it manages to show that ordinary fluctuations, just as risky phenomena in general, are part of the normal set-up of the economy, rather than just pathological phenomena. For this reason, they can still be rationalized in terms of the deep parameters of general equilibrium reflecting rational behaviour in conditions of perfect competition, hence absence of structural change. However,

[4] See e.g. Stiglitz, Sen and Fitoussi (2010). Among the new dimensions considered are those concerning income distribution, health, education, environment, relational and social issues.

to grant consistency with general equilibrium, standard macro regards recessions as being 'occasional displacements' from a trend of stable growth (Lucas, 2011 A, p.3) and rests on methodological features aimed at sterilizing internal Ts. It is such features that the BSA rejects to uncover these Ts.

A. Understanding

The first feature is, to adopt Calvino's terminology, 'precision', i.e. the use of formal models with a view to pursuing prediction as the primary aim of economic theory.[5] Although the use of formal models is not new, a peculiarity of 'precision' in the NE is to regard -- in line with post-modernist trends -- formal tools as reality-creating devices; that is, defining what can be considered as 'real' (see Togati, 2012). One instance is Efficient Markets Theory (EMT) 'producing' new financial instruments. Another is the tendency to construct a theoretical model regarded as an 'artificial economy which behaves through time so as to imitate closely the time series behaviour of actual economies' (Lucas, 1977, p. 11), then single out within available evidence what counts as reality — i.e. what is the object to imitation.

This 'precision' conception undermines stability because it generates an intolerable gap between constructed and 'out-there' reality: it makes people mistake the reality models create for the true one (see e.g. Caballero, 2010, p. 85) with the result of fostering unjustified expectations about their powers and neglecting their limitations. In particular, the EMT has led people to believe that the scientific analysis of risk it provides represented an 'absolutely' correct anchor for decision making.

In the BSA, instead, theory aims at more genuinely seeking to understand 'out-there' reality on the grounds of a different process of abstraction or framing than the standard one (see Dow, 2012). In particular, the BSA may be regarded as part of a broader, ongoing 'neo-modern' project, seeking to accommodate both

[5] For a critique of the deductivist model, see e.g. Dow (2011, 2012) and Lawson (2009, 2012).

the modernist concern for ontology (the emphasis on Ts side places an 'ontological' limitation on standard macro's post-modernist stance, implying that there are only interpretations and no 'hard' facts) and the post-modernist emphasis on construction allowing for multiple interpretations and 'stories' concerning dynamics (see Togati, 2012).

Following its vision of the economy as an open process characterized by irreversible time and complex dynamics, the BSA holds that the aim of understanding is not to predict but to attempt to provide a plausible 'story' about the deep causes of the GR, seeking to explain both its financial- and real-sector roots. For this purpose, the BSA adopts the broad cultural labels proposed by Calvino -- namely 'rapidity', 'multiplicity', 'lightness', 'precision' and 'visibility' -- to capture those features of the NE that cannot be reduced to purely economic terms. For example, 'lightness' is used to capture not just financialization but also the role of intangibles, such as knowledge and social capital, as drivers of growth.

B. What regularities?

Another objectionable feature of standard methodology is the focus on stochastic regularities, which consist of mild fluctuations defined as comovements; i.e. stable patterns among data series. In this regard, Lucas suggested the existence of natural laws of dynamics -- he asked, for example, why is it that, 'in capitalist economies, aggregate variables undergo repeated fluctuations about trend, all of essentially the same character?' (Lucas, 1977, p. 1) -- to explain in terms of self-contained theoretical frameworks. However, Lucas recognizes that the GR defies this interpretation. Rather, it appears as a singular event: 'the GR is deeper not typical' (Lucas, 2011A, p. 15).

This dichotomy between natural laws and exceptions is another factor that undermines stability in the NE for it ties the validity of economic theory to

artificially constructed 'normal' cases,[6] leaving economists in disarray when facing a growing number of exceptions.[7]

The BSA rejects this dichotomy. On the one hand, it suggests that the NE rules out natural laws. The behaviour of the economy in apparently normal times is, to a significant extent, the result of the policy response in crisis times. Thus the GDP is not really 'objective': it does not simply tell a story about 'free markets' or private agents' behaviour as held by Lucas.[8] Indeed in recent times, it is only thanks to unconventional policy measures that a new Great Depression has been avoided. On the other, following its understanding of the economic process as an open system, the BSA considers the *potential* for crises such as the GR 'as the norm rather than an aberration' (Dow, 2011, p. 236). This conclusion rests on two assumptions.

First, following its vision of the economy as a open evolutionary system characterized by irreversible time, the BSA holds that the analysis cannot be restricted to equilibrium states, steady paths or even recurring phenomena, such as financial crises; moreover, the 'laws of motion' of real-world economies cannot be derived in an a priori fashion, but on inductive grounds, that is with reference to some special empirical features. In this regard, the BSA is similar to the French Regulationist school (e.g. Orlean, 2011) or the neo-Schumpeterian approaches such as the Techno-Paradigm approach (e.g. Perez, 2009) or the Mynskian approach (e.g. Wray, 2010, Dow, 2011) that break the whole capitalist

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[6] For example, Lucas notes that the simulations of standard forecasting models 'were presented... as a forecast of what could be expected conditional on a crisis non occurring' (Lucas, 2009. p. 63). Similarly, Sargent notes that standard 'models were designed to describe aggregate economic fluctuations during normal times when markets can bring borrowers and lenders together in orderly ways, not during financial crises and market breakdowns' (Rolnick, 2010, p.30).

[7] As Lucas admits, in DSGE models 'there is a residue of things they don't let us think about. They don't let us think about the U.S. experience in the 1930s or about financial crises ...They don't let us think... very well about Japan in the 1990s.' (Lucas, 2004, p. 23).

[8] He suggests for example that standard theory accounts for normal times, as reflected in secular averages, such as the following: '140 years of 3% production growth and 2% per capita real income growth in the U.S.' (Lucas, 2011 A, p. 15).

evolution into different stages -- in relation to key causal factors, such as technological breakthroughs or changes in institutional regimes or waves of financial innovations -- and focus on the NE as the relevant stage to understanding of the GR. The peculiarity of the BSA, however, is to stress that in the NE all these factors undergo a drastic acceleration and are more interconnected than ever before.

Secondly, to account for this interconnectedness at the analytical level, the BSA, following Keynes, singles out aggregate demand as a key macroeconomic driver. Indeed, while not providing complete dynamic laws, the *General Theory* helps us to carry out one key part of global stability analysis as it captures the forces that determine equilibrium at a point in time. According to the BSA, the other part -- which involves the evolution of aggregate demand through time -- is not a matter of pure theory or 'true' models establishing a 'unique' link between key parameters and evolution. By accommodating, at least partly, post-modern lessons about the role of interpretations and 'construction', the BSA holds that dynamics can be dealt with in terms of 'stories' or scenarios rather than strict formal model building.

C. How do we go beyond abstract shocks?

The standard approach can also be criticized for its emphasis on abstract shocks. Given the assumption of intrinsic stability, standard theory considers the business cycle as the consequence of exogenous factors or random shocks 'displacing equilibrium without disrupting it' (Vercelli, 2009, p. 14). Endogenous factors are ruled out by the presumed effectiveness of market mechanisms, i.e. flexible prices equilibrating demand and supply on all markets. As noted by Ohanian, 'The literature on general equilibrium business cycle models has made considerable progress in understanding how different model economies respond to what we call *abstract shocks*: shocks that do not have a precise definition or acknowledged source' (2010, p. 47). While the early Real Business Cycles models

emphasized productivity shifts alone, current DSGE models consider various extensions, both in terms of models' structure (money, monopolistic competition and nominal price rigidities are usually added to the basic model) and the range of shocks (for example, financial shocks, risk shocks and markup shocks are considered beyond those strictly consistent with the deep parameters assumption, such as technology retardation, changes in preferences or tightness in monetary policy).

This conception is another threat in the NE. First, not unlike Jevons's sunspots, it induces economists to blame factors that the theory cannot explain and policymakers are impotent to face, as Ohanian himself admits: 'There has been less progress on developing and testing theories about the nature and sources of ... abstract shocks' (ibid., p. 47). Secondly, it makes people mistake false stability factors (full price flexibility) for the true ones (price rigidities).

The BSA clarifies this point by pursuing an endogenous perspective, which analyzes the working of the price mechanism in a dynamic historical context rather than in abstract theoretical terms; in particular, this perspective calls for shifting the emphasis from abstract shocks to real internal 'trends' of the economy: that is, from simple technological shifts to faster technological change or 'rapidity', from the simple existence of money or liquidity or financial shocks to the financialization of the economy or 'lightness', from simple globalization to faster market openness or 'multiplicity'.

Now such trends actually show that the NE generates greater volatility and instability not because prices are rigid but for the opposite reason. Indeed one major reason why instability on financial markets has become so endemic is that 'lightness' and 'rapidity' have made the pricing process on these markets more flexible and perfect than in the past (e.g. Orlean, 2011). Similarly, one key reason why aggregate demand is low in Western countries is that 'multiplicity', 'rapidity' and 'lightness' bring about downward pressures on real wages. On these grounds, then, the BSA restores Keynes's conclusion that given money wages are

a useful anchor for decision making rather than the ultimate source of instability and persistence of the GR as for standard theorists (see also Dow, 2011, p. 240).

D. How to account for multiple causes?

Another questionable feature of the standard approach is its reliance on a mechanistic, closed-system view, according to which it is legitimate to use the ceteris paribus method; i.e. to focus on isolated subsets of the complex socio-economic system, even to draw macroeconomic conclusions. As for the analysis of fluctuations, this means in particular that only one main factor is regarded as being responsible for a downturn.

This conception highlights a further threat in the NE insofar as it makes most economists feel overconfident about the value of conclusions and forecasts obtained by neglecting the systemic features of macroeconomics, such as the interconnectedness of the parts. The sterility of the ceteris paribus method is candidly admitted by Lucas himself, who notes for example that until the Lehman failure, standard forecasts were still 'a reasonable estimate of what would have followed if the housing market had continued to be ... the main factor involved in the economic downturn' (Lucas, 2009, p. 63).

In view of the interconnectedness of the NE, the BSA provides instead a 'cumulative' account of the Ts side based on a systemic stance, overcoming the ceteris paribus method as well as the related mechanistic distinctions, such as those between internal propagation mechanisms and exogenous factors or between monetary and real sectors, aimed at ruling out internal instability factors. To make this task feasible, the BSA focuses on the characteristics of a specific type of monetary economy, such as the NE, considering the interrelations between its key objective trends from the start. At the analytical level, to account for both fluctuations and growth, it relies on the principle of effective demand. The main reason is that for the BSA, the objective NE trends do not exercise a direct, mechanical impact upon the economy -- as implied by

standard deterministic approaches -- but influence it only by changing agents' conventions, which underlie the key propensities of Keynesian analysis.

Strictly speaking, this move forces us to go beyond the *General Theory*. While stressing the nature of conventions in his account of agents' behaviour -- namely that they represent broadly rational decisional criteria which are subject to sudden change due to their intrinsic fragility (for example, they fail to provide 'absolutely right' foundations for knowledge capable of erasing doubt from agents' minds) -- Keynes actually failed to discuss how they change through time thus leaving his dynamic analysis concerning the 'laws of motion' of aggregate demand unaccomplished.

To account for the missing part of Keynes's story, the BSA defines the relevant conventions in more specific terms than he does. While Keynes focused on generic features of human behaviour, such as assuming that tomorrow will be like today or imitating other agents, the BSA ties conventions to the relevant socio-economic context. In particular, it holds that instability in the NE occurs because its key objective trends stimulate shifts in the key propensities underlying aggregate demand by influencing a number of agents' socio-psychological perceptions.[9] Here is a list of the most significant (for more details, see Togati, 2006, 2007):

a) perception of 'space': the stronger interaction between 'multiplicity', 'lightness' and 'rapidity' has led to a drastic reduction in distances and various other barriers such as transaction costs;

b) perception of 'time': due to 'rapidity' bringing about greater differentiation of consumer goods and larger and faster information flows, the NE induces a shortening of agents' horizons;

c) perception of 'value': due to the growing role of intangibles in the NE which are an important aspect of 'lightness', it is more difficult to price goods and

[9] As Dow puts it: 'if ..behaviour is based on conventional judgements.. which are subject to non-deterministic...shifts, then the case is strong for theory to address the factors underlying those conventions and shifts in the conventions' (2012, p.85).

services produced. Intangibles call for different criteria for measurement and valuation in firms' accounting than do ordinary physical goods. Moreover, the key interrelated phenomena of 'multiplicity', 'lightness' and 'rapidity' tend to favour the acceptance of widening income gaps and changing standard norms of fairness (such as the huge increase in the difference between top managers and average employee);

d) perception of the 'market': due to the increasing mutual influence between the economic and socio-institutional spheres, agents have different perceptions of the boundaries between private, market-based activities and public intervention and interest. In particular, after the unprecedented scale of bail-outs in the financial sector, it is not clear to what extent capitalism is still based on private enterprise (including the risk of bankruptcy);

e) the state of 'collective trust', which can be regarded as a causally emergent systemic feature,[10] covering what is not captured by the other dimensions. It can be argued that the NE implies a more fragile state of collective trust than in the past because its key trends bring about phenomena, such as the erosion of 'social capital' (for example, due to increasing working time and productivity and the diffusion of lower ethical standards and fraud) and a reduction of the autonomy of individual decisions due to the growing complexity of information.

E- Institutions as reassuring devices

The interpretation of the role of institutions is another feature of standard macro deserving of criticism. While stressing that the market system can only work if there are adequate institutional premises, neoclassical scholars hold that there should be 'optimal rules of the game', such as law enforcement, property rights and flexible markets, that allow the full expression of the stabilizing power of

[10] '...the functioning of the economy in general.., require(s) the presence of a key social convention: trust' (Dow, 2012, p. 86); when, 'trust and confidence break down, we can have…(a) crisis' (Lawson, 2009, p. 768), such as the GR. Following a strong view of emergence that posits the irreducibility of entities to their individual components, such as that put forward by Lawson (2012 B, pp. 348-9), I thus regard Keynes' aggregates as autonomous entities with respect to the standard atomistic model, not unlike fields in Einstein's physics; see e.g. Togati (1998, 2001).

market forces. This view, which is, for example, well expressed by the rhetoric of the 'need to implement structural reforms' so popular in Europe today, has major normative implications. It amounts to assuming that: a) some countries (e.g. the US) represent the benchmark of 'right' institutional set-up; b) the gap between more advanced and less advanced or backward countries can be explained in terms of the failure of the latter to converge to the institutions of the former.

This optimality view undermines stability in the NE. While, in principle, relevant for accounting for long-run growth -- indeed many regard institutions as its 'deep' cause (see e.g., Blanchard, 2009)— it also has negative short-run effects on agents' expectations and the state of collective trust. The emphasis on structural reforms' and politicians' perennial failure to enact them as the ultimate cause of all economic problems leads people to neglect other, possibly more relevant, deep causes, such as a lack of effective demand, and accept 'austerity' as a permanent necessity.

Following its endogenous perspective, the BSA rejects the a priori 'right' set-up view; the efficacy of institutions should be assessed in an ex-post manner, that is in terms of their actual ability to check the sources of private sector instability. To make this point clear, I stress two points. First, the BSA deals with the collective trust issue in an opposite way to the standard model; unlike the latter, it holds that the right level of trust is not automatically generated by the working of an intrinsically stable market economy, but calls for certain structural premises, such as those of ethical or institutional kind.

In particular, the relative stability of the conventional background of capitalism – in which conventions are changeable but sufficiently enduring to allow scientific analysis -- is granted by appropriate institutional anchors that keep collective trust (which is not given forever) continuously at bay. In other words, for the BSA institutions do not simply represent rules of the game but also act as trust-restoring devices (for a similar view, Dow, 2012, pp. 86-9).

Many such devices have been used to tame private sector instability ever since the Great Depression and have now become endogenous or structural, built into the system. I group such devices into what I call the 'visibility' trend, using another Calvino label, including, for example, the pledge of central banks to defend the value of money, the introduction of deposit insurance and key features of the welfare system, such as unemployment benefits or public pensions and health services -- which have accounted for the structural rise of public expenditure over GDP in all advanced countries in the last 80 years (from 3% to over 30% in the US), something which would not seem 'right' of course from the a priori standpoint of optimal rules.

F. Why discretionary policy?

The last objectionable feature of standard macro is the emphasis on tight policy rules as a pre-condition for stability:

> **In the past 50 years, there have been two macroeconomic policy changes in the United States that have really mattered. One of these was the supply-side reduction in marginal tax rates, initiated .... in 1980 ... The other was the advent of 'inflation targeting' ... to the exclusion of other objectives. As a result of these changes, steady GDP growth, low unemployment rates and low inflation rates --once thought to be an impossible combination -- have been a reality in the U.S. for more than 20 years.**
>
> **(Lucas, 2007)**

This policy view undermines stability for one major reason: it generates policymakers' overconfidence about the scientific nature of their knowledge and powers, thus leaving them completely unarmed when facing events such as the GR and forcing them to adopt discretionary policies only as pragmatic, last-resort weapons, rather than well-reasoned first choices. As noted, for example, by the former ECB president: 'As a policy-maker during the crisis I found the available

models of limited help…[more], we felt abandoned by conventional tools … In the absence of clear guidance from the existing analytical framework, [i]n exercising judgement we were helped by …historical analysis …' (Trichet, 2010).

Although the flexible stance taken by policymakers in the GR is better than their blindness during the Great Depression, I suggest that the NE increases the costs of pragmatic policies tremendously, especially for EU countries accepting very stringent fiscal policy rules. One key limitation of pragmatic approaches is their relative failure to learn from the past. In such approaches, reference to 'history' simply amounts to recognizing that discretionary policy moves were taken in previous periods without explaining why. Indeed, the essence of pragmatism is 'doing the right thing without knowing it', and thus without learning, with the result that every time a serious recession occurs policymakers have to start again – it's a bit like reinventing the wheel -- by following the sequence: bold definition of standard 'right' policies, discovery that they do not work in the particular case at hand, need to adopt unconventional measures which last only when things start to improve and then restoration of the standard policy paradigm.

While this sequence is per se painful and time-consuming, it becomes almost intolerable in the rapidly changing NE, in view of the greater role collective trust plays in it. This claim can be made clear in the light of the BSA, which manages to accommodate discretionary policy and 'history' by making reference to agents' conventions. One can note, for example, that the latter defy purely theoretical definitions as they incorporate a changeable element, namely agents' response to objective trends in a given historical period, that make them understandable only ex-post. Thus, from the standpoint of the macroeconomist, conventions can only be taken as they are, as the irreducible starting point of the analysis.

This analysis shows why the BSA studies the evolution of aggregate demand in terms of a historically-oriented perspective rather than abstract theorizing, and provides a rationale for discretionary policy. In particular, by stressing the

autonomy of collective trust as a consequence of conventional behaviour, the BSA allows one to see that 'tight' rules are only a special case of a broader category of trust-keeping moves, which may be necessary to adopt as a response to private sector instability. Indeed, what standard theory takes as 'unique' anchors that always work irrespective of contexts now appear as much weaker in adapting to circumstances.

Inflation-targeting, for example, is not the end-result of a struggle to establish a truly scientific monetary policy, as conventional wisdom would have it, but a common-sense policy in certain contexts (e.g. when hyper-inflation occurs) to be quickly replaced in others, such as the GR, when unemployment or financial instability are more relevant. In other words, in view of the fragility of collective trust one cannot single out on a priori grounds the best policy to keep it at bay; discretionary policy is simply whatever is needed to reach this aim.

3. A deep-causes account of the persistence of the GR

In this section, I argue that the persistence of the GR is caused by a low level of aggregate demand, due not to price rigidity but rooted in the structural changes generated by the NE. This claim can be made clear by carrying out a 'balanced' analysis of the impact of its key trends on demand drivers.

A. Consumption

The NE tends to have an overall negative impact on consumption, both in quantity and 'quality' terms by widening a crucial aspiration gap which the BSA helps us to focus upon. On the one hand, the NE increases consumers' aspirations by generating powerful pressures to increase the propensity to consume, as shown, for example, by indicators such as the reduction in savings ratios, the increasing velocity of circulation of money and its dematerialization. One can note, for example, that, by changing agents' perception of time (i.e. the shortening of their horizons), 'rapidity' creates a growing number of 'artificial'

needs as it brings about greater product differentiation, as well as the expansion of firms' advertising budgets to induce consumers to buy. Moreover, by changing agents' perception of space, 'multiplicity' encourages them to buy more foreign goods, which are, for example, more varied and cheaper than domestic goods. A further pressure to spend arises because of 'lightness' that, by changing agents' changing perception of value, apparently loosens liquidity constraints. In the end, the NE also tends to increase consumption as a compensation for the erosion of social capital or lower 'happiness'.

These pressures are only partly counteracted by opposite tendencies to defer consumption. For example, as shown by the increasing role of confidence indexes in the NE, consumers tend to be structurally more 'anxious' and thus more likely to over-react to adverse news. This accounts for the increasing propensity to hold money that characterizes the GR, as well as other times of depression, and, together with higher unemployment rates, explains why by Central Banks' liquidity injections have not produced inflation so far.

On the other hand, the reality of stagnating wages and adverse income distribution generated by 'multiplicity', 'rapidity' and 'lightness' as well as by shrinking welfare expenditure, implies that this tendency cannot be accommodated and effective demand is bound to lag behind aspiration levels. This gap in the NE, which can be taken as a symptom of people's 'unhappiness', is closed at least partially by increasing personal debt. In other words, the 'quality' of consumption is deteriorating as it is increasingly debt-financed (for a similar conclusion see e.g. Fitoussi and Stiglitz, 2009, Crotty, 2009). This claim carries over to investment as far as residential housing is concerned.

B. Propensity to invest

The NE tends to have an overall negative impact on investment too. The positive effects of 'rapidity' (e.g., greater opportunities for innovation in new sectors such as the green economy opened by faster technological change) and 'lightness' (e.g., easier access, in principle, to capital markets) are more than compensated

by several negative effects, such as the consumers' widening aspiration gap (generating a negative accelerator effect on investment) and agents' changing perception of space and collective trust (in particular, the erosion of social capital in the shape of 'national' identity or ties) induced by 'multiplicity', which makes it easier for firms to invest abroad.

A further tendency to decrease real investment is due to agents' changing perceptions of value induced by 'lightness', that is the greater relative attractiveness of financial markets, which leads manufacturing firms to focus more on returns from financial investment rather than on accumulation of real capital assets. Moreover, the 'quality' of their investment is also negatively influenced by typical features of financial markets such as short-termism and bad practices, such as fraud and false accounting.

In the end, non-financial business firms may defer investment because their long-term expectations tend to get more unstable. In the complex, rapidly changing NE, all its trends combine to make it more difficult for firms to estimate expected returns from investment. For example, this is the effect of larger and faster information flows increasing uncertainty about future scenarios, as well as the greater weight of intangibles.

C. Exports

From the standpoint of Western countries, the NE also brings about lower exports. They may be hit by the growing volatility of financial markets and exchange rates as well as the faster transmission of financial and real disturbances across countries produced by the combination of all the NE trends. Moreover, exports are reduced by 'multiplicity', which favours production in emerging countries.

D. Public expenditure

In the end, the NE -- deviating from the 'visibility' trend ever since the 1930s -- also generates a tendency to cut public expenditure for welfare and investment purposes, thus increasing rather than reducing global instability generated by the lack of aggregate demand in the private sector. Strictly speaking, this tendency does not imply a reduction in total public expenditure (G) in relation to GDP, as well as public debt/GDP ratios. Although the NE was widely celebrated for its tendencies towards deregulation and reduction of budget deficits and the role of the state in the economy, the GR marks a sharp reversal of such tendencies by changing dramatically the composition of G: in particular, in order to reassure financial markets, governments' massive financial sector bail out has been at least partly compensated by welfare cuts.

4. Conclusion

This paper has tried to explain the persistence of the GR by uncovering its 'deep' causes, rather than by insisting on price rigidities as in standard macro. In contrast with proximate-causes accounts focusing on the link finance-aggregate demand, the primary aim of the analysis developed here on the grounds of the BSA -- a broad interdisciplinary perspective on macro stability bringing together economic, institutional and cultural factors --- is to explain why the financial crisis occurred. BSA's contribution is stress that this is rooted not only in developments within the financial system but also in a wider range of structural changes of the NE depressing aggregate demand, especially in advanced countries.

Two distinct aspects of this problem can be noted. The first is quantitative. The NE reduces aggregate demand by generating private sector instability (i.e. less consumption, investment and exports) that is not compensated by a sufficient volume of public expenditure. The second is more qualitative. The reason why low private sector demand occurs is that the NE generates a declining collective trust or 'unhappiness', which is due to factors such as the erosion of social capital (due to factors including short-termism and greater

permeability to fraudulent practices) and a widening aspiration gap: while the propensity to consume was stimulated by technological change and globalization, effective demand was held back by these very same forces bringing about adverse income and wealth distribution. In order to bridge this gap, people were then almost forced to go into debt, backed by waves of financial innovation and the influence of efficient markets theories. Thus new investment projects were not being stimulated.

This analysis has some significant implications in terms of policy. To cure the GR it is not enough to rule out frictions or change the incentive structure or approve new restrictive financial legislation or simply increase public expenditure. In view of the more prominent role of collective trust in the NE, what is needed are subtler confidence-restoring moves than in the past. In particular, it is crucial that policymakers break with the painful pragmatic policy sequence amounting to accept 'right' (i.e. Keynesian) policies only as last-resort moves in bad times and embrace discretionary policy as a deliberate first-choice for all times. This does not imply that public debts can increase forever but that if governments stick to a coherent policy view throughout, which includes for example the need to reassure consumers by preserving the welfare system, they can do much to reassure also financial markets.

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